INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes and Regulations involved	2
Statement	3
Argument	9
Conclusion	12

CITATIONS

Cases:

Brown-Rogers-Dixson Co. v. *Commissioner*, 122 F. 2d 347	10
Commissioner v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182	10
Comstock v. *Group of Investors*, 335 U.S. 211	11
Dobson v. *Commissioner*, 320 U.S. 489	9
1432 Broadway Corp. v. *Commissioner*, 4 T.C. 1158, affirmed, 160 F. 2d 885	9
Gooding Amusement Co. v. *Commissioner*, 236 F. 2d 159, certiorari denied March 11, 1957	12
Janeway v. *Commissioner*, 147 F. 2d 602	9
Kelley, John, Co. v. *Commissioner*, 326 U.S. 521	9, 10, 11
Kraft Foods Co. v. *Commissioner*, 232 F. 2d 118	10, 11
Reed v. *Commissioner*, decided March 15, 1957 (C.A. 2)	12
Staked Plains Trust v. *Commissioner*, 143 F. 2d 421	10
Talbot Mills v. *Commissioner*, 326 U.S. 521	9, 10
Wetterau Grocer Co. v. *Commissioner*, 179 F. 2d 158	9

Statutes:

Internal Revenue Code of 1939:	
Sec. 23(b) (26 U.S.C. 1952 ed., Sec. 23(b))	2
Sec. 112(i) (26 U.S.C. 1952 ed., Sec. 112(i))	5
Sec. 115(a) (26 U.S.C. 1952 ed., Sec. 115(a))	2
Sec. 291(a) (26 U.S.C. 1952 ed., Sec. 291(a))	8

Page

Statutes—Continued

Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 112(k) 4
Revenue Act of 1934, c. 277, 48 Stat. 680:
Sec. 23(b) 3
Sec. 112(i) 5
Sec. 115(a) 3
Revenue Act of 1936, c. 690, 49 Stat. 1648:
Sec. 23(b) 3
Sec. 112(i) 5
Sec. 115(a) 3
Revenue Act of 1938, c. 289, 52 Stat. 447:
Sec. 23(b) 3
Sec. 112(i) 5
Sec. 115(a) 3

Miscellaneous:

Federal Rules of Civil Procedure, Rule 52 9
4 Mertens, *Law of Federal Income Taxation*, Sec. 26.10c 10
Treasury Regulations 86, Art. 23(b)-1 3
Treasury Regulations 94, Art. 23(b)-1 3
Treasury Regulations 101, Art. 23(b)-1 3
Treasury Regulations 103, Sec. 19.23(b)-1 3
Treasury Regulations 111, Sec. 29.23(b)-1 3

IN THE

Supreme Court of the United States

October Term, 1956

No. 838

THE GREGG COMPANY OF DELAWARE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 3a-12a)[1] are reported at 23 T. C. 170. The opinion of the Court of Appeals (Pet. 11-18) is reported at 239 F. 2d 498.

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[1] Record references are to the appendix to the petitioner's brief filed in the Court of Appeals.

JURISDICTION

The judgment of the Court of Appeals (Pet. 19) was entered on December 17, 1956. The petition for a writ of certiorari was filed on March 15, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

QUESTION PRESENTED

Whether the record warrants the Tax Court's conclusion, affirmed by the court below, that so-called interest on "Income Notes"—hybrid securities possessing the characteristics of both conventional debt and conventional equity issues—paid by the taxpayer corporation to the stockholders of its parent corporation, constituted nondeductible dividend distributions, and not deductible interest on indebtedness.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *.

* * * *

(26 U. S. C. 1952 ed., Sec. 23(b).)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" * * * means any distribution made by a

> corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.
>
> * * * *
>
> (26 U. S. C. 1952 ed., Sec. 115(a).)

The provisions of Sections 23(b) and 115(a) of the Revenue Acts of 1934, c. 277, 48 Stat. 680; 1936, c. 690, 49 Stat. 1648; and 1938, c. 289, 52 Stat. 447, are substantially the same.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> Sec. 29.23(b)-1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *.
>
> * * * *
>
> * * * So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. * * *

The provisions of Article 23(b)-1 of Treasury Regulations 86, 94, and 101, promulgated under the Revenue Acts of 1934, 1936, and 1938, respectively, and of Section 19.23(b)-1 of Treasury Regulations 103, promulgated under the Internal Revenue Code of 1939, are the same.

STATEMENT

The facts, as found by the Tax Court (R. 3a-12a) and summarized by the Court of Appeals (Pet. 13-17), are as follows:

The Gregg Company, Ltd., a New York corporation (hereinafter called New York, or the parent), was until 1933 engaged in the business of manufacturing and selling railway cars and equipment in various parts of the world. All but 630 of its 18,903 outstanding shares of $100 par value stock were owned by members of the Gregg family. (R. 4a-5a.) New York owned all of the outstanding stock (except qualified shares) of Societe Gregg d'Europe, a Belgian manufacturing corporation (hereafter called Belgian). It also financed and controlled Belgian's operations, and sold its products. (R. 5a; Pet. 13.)

In 1933 the common stockholders of New York (i.e., the Gregg family), after consulting accountants and attorneys, devised a plan for avoiding United States corporation income taxes on foreign profits by means of a transfer of New York's foreign operating assets to a foreign corporation, but without subjecting New York or its stockholders to tax liability on the transfer under Section 112(k) of the Revenue Act of 1932.[2] Pursuant to the plan, the Gregg Com-

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[2] Section 112(k) of the Revenue Act of 1932, c. 209, 47 Stat. 169, provided:

> (k) *Foreign Corporations.*—In determining the extent to which gain shall be recognized in the case of any of the exchanges or distributions (made after the date of the enactment of this Act) described in subsection (b)(3), (4), or (5), or described in so much of subsection (c) as refers to subsection (b)(3) or (5), or described in subsection (d) or (g), a foreign corporation shall not be considered as a corporation unless, prior to such exchange or distribution, it has been established to the satisfaction of the Commissioner that such exchange or distribution is not in pursuance of a

pany of Delaware (hereafter called the taxpayer) was organized under the laws of Delaware, and the assets of New York relating to its foreign operations were transferred to the taxpayer on October 31, 1933, in exchange for all of taxpayer's 2,000 shares of no par value common stock and $1,000,000 face amount of taxpayer's "Fifty-Year 4% Income Notes." The notes were immediately distributed by New York pro rata to its stockholders, and the par value of New York's common stock was reduced from $100 to $5 per share, an amount approximating the book value of the transferred assets. A new corporation (hereafter called Panama) was also organized under the laws of Panama, and all but $2,000 of the assets which the taxpayer received from New York were on the same day (October 31, 1933) transferred by the taxpayer to Panama in exchange for $1,000,000 par value four per cent noncumulative voting preferred stock of Panama. The common stock of Panama was subscribed for by New York's common stockholders on a share for share basis at ten cents per share, or a total of $1,890.30 for 18,903 shares. Panama then took over the operation of the foreign business, using Belgian as the manufacturing corporation. (R. 5a-6a, 10a-12a, 22a-24a; Pet. 13-14.)

The "Fifty-Year 4% Income Notes" issued by the taxpayer were to mature February 1, 1984. They bore interest from January 1, 1934, at a rate not to

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plan having as one of its principal purposes the avoidance of Federal income taxes.

Section 112(i) of the Revenue Acts of 1934, 1936 and 1938, *supra*, and of the Internal Revenue Code, is substantially the same.

exceed four per cent payable on February 1 of each succeeding year. The interest was payable "out of the surplus net earnings and income for the preceding calendar year but only if and to the extent that the surplus net earnings and income of the Company shall suffice for such payment; such interest shall not be cumulative and no part of the interest hereon for the payment of which the surplus net earnings and income for any interest year shall be insufficient shall be a charge upon or shall be paid from the income of any other year." Current expenses of the business, taxes, insurance charges, other interest charges, and such sums as the board of directors in their discretion might set aside as a reserve for any proper purpose or contingency were to be deducted from the gross earnings for the interest period in determining the surplus net earnings applicable to the payment of interest. The amounts available up to four per cent were to be paid promptly "unless in the judgment of the Board of Directors, the net quick asset position of the Company shall render it undesirable to make such payment," but any earned interest thus withheld was to accumulate and be payable without interest when the board might determine or at maturity if not paid prior thereto. The determination of the board of directors as to the surplus net earnings applicable to the payment of interest was to be final and conclusive. The notes were subject to redemption in whole or in part at any time prior to maturity upon ten days' notice, were to become due and payable immediately in the event of liquidation or insolvency of the company, and were trans-

ferable. They contained no provision subordinating payment of principal to claims of general creditors, were not secured, and had no voting privileges. (R. 6a-8a, 54a-58a; Pet. 14-15.)

Panama paid to the taxpayer $40,000 in each year from 1935 through 1939, as dividends on the preferred stock. The taxpayer paid out all of this money, as received, to the holders of its notes, as interest on the notes. In 1939 Panama redeemed $319,000 of its preferred stock, and the taxpayer in turn redeemed an equal amount of its notes. Thereafter, for each of the years 1940 through 1949, except 1945 and 1946, Panama paid to the taxpayer $27,236 as dividends on the remaining preferred stock, and for each of the same years the taxpayer paid to the holders of its notes substantially the same amount ($27,233.76) as interest. (R. 8a, 71a; Pet. 15.)

At the hearing, William B. Gregg, the only witness called for the purpose, testified that the taxpayer issued notes instead of preferred stock because members of the Gregg family expected to bequeath the notes to other members of the family whom they did not wish to have voting rights, and because notes having a maturity date would have more value than preferred stock. (R. 8a-9a, 81a.)

There was never any intention that the taxpayer would engage in conventional business operations. It was intended that Panama would take over from New York the operation of the foreign business, and that taxpayer would own Panama's preferred stock. The taxpayer, in this sense, was a mere conduit to receive dividends on the preferred stock of Panama,

which it was allowed to own, and to distribute those same amounts to the holders of its income notes. It had no other source of income and no means of paying the principal of the notes except from the retirement of the preferred stock of Panama. Taxpayer was originally formed in order to effectuate a tax-free reorganization, the purpose of which was the elimination of a corporate tax on the foreign profits of the Gregg operations; the reorganization was accomplished, and the taxpayer served continuously as a holding company from that date forward, reporting as its corporate income the dividends it received from the corporate stock it held. (R. 6a, 10a-11a; Pet. 18.)

In its income and excess profits tax returns for the taxable years (1935 through 1944, and 1947 through 1949), the taxpayer reported as income the dividends received as holder of Panama's preferred stock, and deducted like amounts as interest paid to the holders of its "Fifty-Year 4% Income Notes." The Commissioner disallowed the claimed deductions and determined deficiencies accordingly.[3] (R. 4a.) The Tax Court sustained the Commissioner's determination. The Court of Appeals affirmed. (R. 9a-12a; Pet. 19.)

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[3] For each year (except 1949) the Commissioner also added a penalty for failure to file a timely return, as prescribed in Section 291(a) of the Internal Revenue Code of 1939 and corresponding provisions of prior Revenue Acts. The taxpayer conceded below that if the deficiency determinations were correct, then the additions to the deficiencies were also correct. (R. 4a.)

ARGUMENT

1. In affirming the Tax Court's determination that the payments which the taxpayer made to the stockholders of its parent corporation on the income notes in question were dividend distributions, and not deductible interest payments, the decision below correctly applies the principles established by this Court in *John Kelley Co.* v. *Commissioner* (decided with *Talbot Mills* v. *Commissioner*), 326 U. S. 521. There it was held that whether a corporate payment constitutes deductible interest or a nondeductible dividend distribution presents a question of ultimate fact in each case, depending upon whether the true relationship of the parties is that of debtor-creditor or corporation-stockholder. In determining that relationship, this Court held that consideration should be given to (*Kelley* case, pp. 526, 530) "the characteristics of * * * the obligations in question and the surrounding circumstances," and it warned that "no one characteristic * * * can be said to be decisive."[4] See, e. g., *1432 Broadway Corp.* v. *Commissioner*, 4 T. C. 1158, affirmed, 160 F. 2d 885 (C. A. 2d); *Wetterau Grocer Co.* v. *Commissioner*,

[4] While it is true that in sustaining the Tax Court's findings as to the nature of the corporate obligations involved in the *Kelley* and *Talbot Mills* cases, this Court applied the "*Dobson*" rule (*Dobson* v. *Commissioner*, 320 U. S. 489) governing the scope of appellate review of Tax Court decisions, and that rule has since been supplanted by the "clearly erroneous" rule (Rule 52(a), Federal Rules of Civil Procedure), the *Kelley* and *Talbot* cases, nevertheless, still stand for the proposition that the question is one of ultimate fact for the Tax Court, whose decision may not be upset if supported by substantial evidence. See *Janeway* v. *Commissioner*, 147 F. 2d 602 (C. A. 2d).

179 F. 2d 158 (C. A. 8th); *Brown-Rogers-Dixson Co.* v. *Commissioner*, 122 F. 2d 347 (C. A. 4th); *Staked Plains Trust* v. *Commissioner*, 143 F. 2d 421 (C. A. 5th); *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182 (C. A. 7th); 4 Mertens, *Law of Federal Income Taxation*, § 26.10c.

In the instant case, the Court of Appeals—distinguishing its prior decision in *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (C. A. 2d)—found that (Pet. 16) "Here * * * we are confronted with 'hybrid' securities" and that it was therefore "necessary to consider the individual provisions of the Income Notes and the history of their issuance and subsequent treatment in order to determine whether they represent an actual indebtedness or, in reality, equity capital." Applying the tests laid down in the *Kelley* and *Talbot Mills* cases, *supra*, it concluded that the record (Pet. 17-18) "clearly support[s] the Tax Court conclusion that * * * [the notes] were never evidences of indebtedness, but actually represented disguised equity capital." That conclusion is supported by substantial evidence.[5] Under the settled rule of this Court, the concurrent factual deter-

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[5] For example, as to the circumstances surrounding the issuance of the taxpayer's notes to its parent's stockholders, there was evidence, as summarized by the Court of Appeals, that the exchange of the taxpayer's capital stock and income notes for its parent's assets was merely a (Pet. 13) "first step" in the successful execution of a plan "to avoid United States income taxes assessed against New York upon profits made elsewhere," and further that (Pet. 17):

> The Notes were not issued for new capital obtained by the Greggs from outside sources, nor for borrowed money. They were issued in exchange for the assets of

minations of both courts below are final here, in the absence of clear error. *Comstock* v. *Group of Investors*, 335 U. S. 211, 214.

2. The petition alleges no direct conflict between the instant case and the decisions of this Court or of other Courts of Appeals.[6] Nor does the so-called (Pet. 10) "thin capitalization question" warrant further review of the case by this Court. Contrary to the taxpayer's assertion that the disproportionate ratio of debt to capital was (Pet. 10) "the *moving* factor in the disallowance of the interest deduction"

New York, which, like the petitioner, was a Gregg family corporation. Since the Notes were distributed to the shareholders of New York in proportion to their equity interests in that company, the relative interests in the Gregg businesses of each New York stockholder was not changed. In 1939, when the taxpayer's Notes held by Louis Gregg and his family were retired, the Panama company also retired an equal amount of its preferred stock, thus illustrating the correlation between the taxpayer's Income Notes and the equity interests in the Gregg enterprises.

As to the notes themselves, among other things, the record showed that they were unsecured, were to mature fifty years later, and were redeemable at any time; they carried no definite interest rate, only "a rate not to exceed 4%"; interest was payable out of "surplus net earnings" for the preceding year, and "only if and to the extent that the surplus net earnings and income of the Company shall suffice for such payment"; interest was noncumulative; and even if the obligation to pay arose, interest was not payable if in the judgment of the taxpayer's directors its "net quick asset position" rendered it "undesirable to make such payment." (R. 7a, 54a-56a; Pet. 14-15.)

[6] Indeed, the only suggested conflict (Pet. 9) is between the *Kelley* decision of this Court and the Second Circuit's prior decision in the *Kraft* case.

(emphasis supplied), the simple fact is, as the taxpayer concedes, that (Pet. 10) "thin capitalization was not discussed either by the Tax Court or by the Court of Appeals in the instant case," and, having in mind the articulated bases for the decision below, it cannot be said "that the *other* incidents of the transactions did not warrant the inference reached, *viz.*, that the advances were contributions of risk capital and were so intended by the parties to the transactions" (emphasis supplied). *Reed* v. *Commissioner*, decided March 15, 1957 (C. A. 2d).

The question here is substantially the same as that presented in *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C. A. 6th), in which this Court recently denied a petition for certiorari.[7] There is no more reason for further review of this case than of that one.

CONCLUSION

The decision of the court below is correct, there are no conflicting decisions, and further review is not warranted. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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APRIL, 1957.

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[7] No. 709, This Term, certiorari denied March 11, 1957.

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